



***FINANCIAL SECTION
AUDITOR'S REPORTS***

PAGE INTENTIONALLY LEFT BLANK



UNITED STATES RAILROAD RETIREMENT BOARD

OFFICE OF INSPECTOR GENERAL

To the Board Members:

The following report presents the results of the Office of Inspector General's (OIG) audits of the financial statements of the Railroad Retirement Board (RRB) as of and for the fiscal years ended September 30, 2007 and 2006.

OPINION ON THE FINANCIAL STATEMENTS

We have audited the accompanying balance sheet of the RRB as of September 30, 2007 and 2006; the related statements of net cost, changes in net position, and budgetary resources for the years then ended; and the statements of social insurance as of January 1, 2007 and 2006.

We did not audit the financial statements of the National Railroad Retirement Investment Trust (NRRIT). The net assets of the NRRIT represent approximately 86% and 85% of the total assets reported by the RRB for fiscal years 2007 and 2006, respectively. NRRIT assets represent approximately 97% and 96% of the reported Railroad Retirement program's social insurance fund balance as of January 1, 2007 and 2006, respectively. Related changes in the net value of investments held by the NRRIT represent approximately 24% and 15% of the financing sources reported by the RRB for fiscal years 2007 and 2006, respectively.

Pursuant to the Railroad Retirement and Survivors' Improvement Act of 2001, the NRRIT retains the services of an independent auditor to opine on its financial statements. With respect to the assets of the NRRIT as of September 30, 2007, September 30, 2006, January 1, 2007 and January 1, 2006, the financial data of the NRRIT were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for the NRRIT, is based solely on the report of the other auditors.

In our opinion, the financial statements of the RRB referred to above, including the accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, the financial position of the RRB, its consolidated net cost of operations and changes in net position, and combined budgetary resources as of and for the fiscal years ended September 30, 2007, and 2006; and the financial condition of the Railroad Retirement program as of January 1, 2007 and 2006.

As described in the statement and related notes, the statement of social insurance presents the actuarial present value of the future income to be received, and expenditures to be paid to or on behalf of participants in the Railroad Retirement program during a period sufficient to illustrate the program's long-term sustainability. In preparing the statement of social insurance, management considers and selects assumptions and

data that it believes provide a reasonable basis for the assertions in the statement. However, because of the large number of factors that affect the statement of social insurance and the fact that future events and circumstances cannot be known with certainty, there will be differences between the estimates in the statement of social insurance and the actual results, and those differences may be material.

The RRB's statement of social insurance presents the fund balance of the Railroad Retirement program and the related estimate of actuarial surplus which is computed by adding the fund balance to the estimated excess (or shortfall) of the present value of future income over the present value of future revenue for the 75 year projection period. These additional line items are presented to ensure that a reader would not be misled about the financial condition of the program. The program's current financing structure creates an inverse relationship between income and program assets; thus, the financial condition of the program cannot be understood without direct reference to the fund balance and the related actuarial surplus or deficiency. This relationship is disclosed in Note 15 to the financial statements.

Emphasis of Matters

The RRB discloses transactions with related parties in Note 2 to the financial statements. The RRB, Social Security Administration and Centers for Medicare and Medicaid Services are parties to a financing arrangement described as a financial interchange. Under this arrangement, transfers-in from the Social Security Administration's Old-Age and Survivors Insurance and Disability Insurance trust funds and transfers-out to the Federal Health Insurance trust fund represent approximately \$3.6 billion (net), or approximately 26% of the approximately \$13.8 billion in total financing sources reported on the RRB's statement of changes in net position for FY 2007.

REPORT ON INTERNAL CONTROL

In planning and performing our audit, we considered the RRB's internal control over financial reporting and compliance.¹ We did this to determine our procedures for auditing the financial statements and to comply with OMB audit guidance, not to express an opinion on internal control. Accordingly, we do not express an opinion on internal control over financial reporting and compliance or on management's assertion on internal control included in Management's Discussion and Analysis.

With respect to previously reported control deficiencies, our current-year evaluation disclosed that RRB management has completed action to strengthen controls over performance measurement, the actuarial projection process and compliance with the Prompt Payment Act. Agency efforts to correct weaknesses in its information security program are not yet complete and the previously reported material weakness continues to exist. We will also continue to identify financial reporting as an area of significant deficiency until recently implemented controls have been in place and operating for a period sufficient to permit evaluation.

¹ The definition of internal control as it relates to the basic financial statements is presented in the footnotes on page 5.

Our evaluation of internal control during FY 2007 disclosed a material weakness, not previously reported, in the method used to develop the social insurance fund balance for the Railroad Retirement program.²

Although not considered to be material weaknesses or significant deficiencies, we will report other matters involving internal control and its operation to RRB management in a separate letter.

Material Weaknesses

Information Security

During FY 2007, the OIG evaluated information security pursuant to the provisions of the Federal Information Security Management Act.³ Our review disclosed continued weaknesses in many areas of the RRB's information security program. Significant deficiencies in program management and access controls make the agency's information security program a source of material weakness in internal control.

RRB efforts to strengthen information security continue and progress is being made; however, previously identified significant deficiencies in access controls, risk assessments, and periodic testing and evaluation continue to exist. In addition, the agency's information security program is not yet fully compliant with current requirements for risk based policies and procedures, a certification and accreditation program, a comprehensive remedial action process, continuity of operations planning, and inventory of systems.

Agency management is working to address the weaknesses in its information security program. Although some progress has been made, much work remains to be completed.

Social Insurance Fund Balance

The RRB does not have a consistent theory under which it computes the Railroad Retirement program's fund balance for social insurance reporting.

The actuarial assumptions and methods used to measure amounts in the statement of social insurance for financial accounting and disclosure purposes should represent the

²A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process or report financial data reliably in accordance with generally accepted accounting principles (GAAP) such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

³ "Fiscal Year 2007 Evaluation of Information Security at the Railroad Retirement Board," OIG Report #07-08, September 27, 2007.

agency's best estimates. The program fund balance at the beginning of the period is important because it impacts estimated future tax rates on which estimates of future income are based. In addition, the availability of the fund balance to offset any long term estimated actuarial liability created by a shortfall of income over expense is important to understanding the financial condition of the Railroad Retirement program.

During our audit, we observed that the RRB had used different methods to compute its social insurance fund balance as of January 1, 2006, compared with January 1, 2007, including some amounts previously excluded and excluding other amounts that had been previously included. The impact of the social insurance fund balance on actuarial projections of income and expense for the Railroad Retirement program is described in Note 15 to the financial statements.

The RRB's actuarial projections also include estimates of future tax rates. Inquiries of management disclosed that neither the 2006 nor the 2007 fund balance had been computed on the same basis used to compute tax rates under the account benefit ratio method for which purpose the agency includes the net assets of the NRRIT as computed under generally accepted accounting principles (GAAP) for private investment companies, the same method used to report on NRRIT-held assets in the RRB's balance sheet.

Inconsistencies in fund balance methodology undermine management's assertion of best estimate and make comparative presentation less meaningful. We are in the process of discussing this finding with responsible agency management and expect to make a formal recommendation for corrective action at a later date.

Significant Deficiencies

Financial Reporting

Over the years agency responsibility for financial reporting has grown from preparation of financial statements within six months of fiscal year-end, to publication of an annual performance and accountability report within 45 days of fiscal year-end. Publication of that report is an exercise in public accountability of which preparation of accurate, reliable financial statements is but a single part.

The Bureau of Fiscal Operations (BFO) is responsible for preparing agency financial statements and publishing the RRB's annual performance and accountability report. During our FY 2006 audit, we observed that existing procedures and controls over its financial reporting process needed to be updated to fully ensure the quality of the RRB's response to the expanding responsibilities and short timeframes inherent to the Federal financial reporting process. We also observed that the existing control framework was overly reliant on the OIG's annual audit of the financial statements to ensure the completeness and accuracy of the performance and accountability report.

During FY 2007, we found the agency-reporting process much improved by the efforts of BFO management and staff. BFO responded to the OIG's prior year finding by implementing OIG-recommended corrective actions and by implementing an enhanced year-end financial statement review process of their own design.

Although the process has been strengthened, the corrective action has not yet been in operation for a full fiscal year. Accordingly, the OIG continues to cite financial reporting as an area of significant deficiency in internal control pending a full year of experience demonstrating the effectiveness of controls over time.

COMPLIANCE WITH LAWS AND REGULATIONS

Our tests of compliance with selected provisions of laws and regulations disclosed no instances of non-compliance that are reportable under U.S. generally accepted government auditing standards or OMB guidance. However, the objective of our audit was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion.

CONSISTENCY OF OTHER INFORMATION

Management's Discussion and Analysis, required supplementary information, and other accompanying information contain a wide range of data, some of which are not directly related to the financial statements. We did not audit and do not express an opinion on this information. However, we compared this information for consistency with the financial statements and discussed the methods of measurement and presentation with RRB officials. Based on this limited work, we found no material inconsistencies with the financial statements or nonconformance with OMB guidance.

OBJECTIVES, SCOPE, AND METHODOLOGY

RRB management is responsible for (1) preparing the annual financial statements in conformity with U.S. generally accepted accounting principles, (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act (FMFIA) are met, and (3) complying with applicable laws and regulations.⁴

We are responsible for obtaining reasonable assurance about whether the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles. We are also responsible for (1) obtaining

⁴**Internal Control** as it relates to the financial statements is a process, affected by the agency's management and other personnel, designed to provide reasonable assurance that the following objectives are met: (1) Reliability of financial reporting - transactions are properly recorded, processed, and summarized to permit the preparation of the Basic Statements in accordance with generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition; and (2) Compliance with applicable laws, regulations, and government-wide policies - transactions are executed in accordance with laws governing the use of budget authority, government-wide policies, and laws identified by OMB, and other laws and regulations that could have a *direct and material effect on the Basic Statements*.

a sufficient understanding of internal control over financial reporting and compliance to plan the audit, (2) testing compliance with selected provisions of laws and regulations that have a direct and material effect on the financial statements, and any other laws for which OMB audit guidance requires testing; and (3) performing limited procedures with respect to certain other information appearing in these annual financial statements. In order to fulfill these responsibilities, we:

- examined, on a test basis, evidence supporting the amounts and disclosures in the proprietary and budgetary financial statements;
- assessed the accounting principles used and significant estimates made by management in preparing the proprietary and budgetary financial statements;
- assessed the factors, data, assumptions and model used to prepare the long-term actuarial projections presented in the statement of social insurance;
- evaluated the overall presentation of the financial statements;
- obtained an understanding of the entity and its operations, including its internal control related to financial reporting, compliance with laws and regulations (including execution of transactions in accordance with budget authority);
- obtained an understanding of the recording, processing, and summarizing of performance measures as reported in Management's Discussion and Analysis;
- tested relevant internal controls over financial reporting and compliance, and evaluated the design and operating effectiveness of internal control;
- considered the process for evaluating and reporting on internal control and financial management systems under the FMFIA; and
- performed tests of compliance with selected provisions of laws and regulations, including laws governing the use of budget authority, and other laws and regulations that could have a direct and material effect on the RRB's basic financial statements:
 - Anti-Deficiency Act, as amended;
 - provisions of the Railroad Retirement Act governing financing and the payment of benefits;
 - provisions of the Railroad Unemployment Insurance Act governing financing and the payment of benefits; and
 - provisions of the Social Security Act that provide for certification of benefits to the RRB for payment (42 U.S.C. § 405(i)).

We did not evaluate all internal controls relevant to operating objectives as broadly defined by the FMFIA, such as controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to controls over financial reporting and compliance. Because of inherent limitations in internal control, misstatements due to error or fraud, losses, or noncompliance may

nevertheless occur and not be detected by our audit. We also caution that projecting our evaluation to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with controls may deteriorate. We also caution that our internal control testing may not be sufficient for other purposes.

We did not test compliance with all laws and regulations applicable to the RRB. We limited our tests of compliance to those laws and regulations that had a direct and material impact on the RRB's financial statements or that we deemed otherwise applicable to the financial statements for the fiscal year ended September 30, 2007. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

The NRRIT was established pursuant to the Railroad Retirement and Survivors' Improvement Act of 2001 (Public Law 107-90). Under that law, the NRRIT is not a department, agency or instrumentality of the Government of the United States. In addition, the law specifically exempts the NRRIT from compliance with Title 31, United States Code which governs the monetary and financial operations of the Federal government. The law also provides that the NRRIT annually engage an independent, qualified public accountant to audit the financial statements of the NRRIT. Accordingly, the OIG has not audited the books and records of the NRRIT, nor had any input into the selection of the independent accountant retained by the NRRIT, nor provided oversight to that firm in the execution of their responsibilities. Our opinion on the RRB's financial statements, insofar as it relates to the amounts included for the NRRIT, is based solely on the report of the auditor retained by the NRRIT, and our assessments of internal control and compliance do not extend to the operations of the NRRIT.

Except to the extent that the foregoing arrangement may have affected the planning and execution of our audit, we performed our work in accordance with U.S. generally accepted government auditing standards and OMB audit guidance.

RRB MANAGEMENT'S COMMENTS

The offices of the Chief Financial Officer and the Board Members have reviewed our report and offered comments expressing management's intention to address the material weaknesses described in our report.

With respect to information security, management notes that information security is a significant challenge to which they have devoted substantial effort and resources in recent years and that they will continue to do so. In FY 2008, the agency plans to resolve the remaining audit recommendations related to this material weakness and then evaluate whether the material weakness has been eliminated.

Regarding the computation of the social insurance fund balance, responsible agency managers will work with the NRRIT to obtain more complete, reliable information about the NRRIT's financial position in order to have a consistent basis for preparing the fund balance.

In their reply, they also thank OIG management and staff for working closely and cooperatively with agency personnel to help ensure that the RRB would be able to meet this year's reporting deadline of November 15th.

The full text of management's response follows as an attachment to this report.

A handwritten signature in black ink, reading "Martin J. Dickman". The signature is fluid and cursive, with a long horizontal flourish extending to the right.

Martin J. Dickman
Inspector General

November 2, 2007, except for matters relating to the fair market value of the net assets of the NRRIT as of September 30, 2007, and amounts related to the NRRIT included in the RRB's social insurance fund balance as of January 1, 2007, as to which the date is November 15, 2007.

**MEMORANDUM****NOV 13 2007**

TO : Martin J. Dickman
Inspector General

FROM : Kenneth P. Boehne *Kenneth P. Boehne*
Chief Financial Officer

SUBJECT: FY 2007 Financial Statement Audit – Auditor’s Report;
Re: Your memorandum dated November 7, 2007

My office, and those of the Board Members, have reviewed your draft report and have the following comments.

You reported material weaknesses in your draft report dealing with information security and the social insurance fund balance. Regarding the former, the Railroad Retirement Board recognizes that information security is a significant challenge. We have devoted substantial effort and resources to this area in recent years and will continue to do so. In fiscal year 2008, the Bureau of Information Services plans to resolve the remaining audit recommendations related to this material weakness and then evaluate whether the material weakness has been eliminated. Regarding the latter, the Bureau of the Actuary will work with the Bureau of Fiscal Operations and the National Railroad Retirement Investment Trust (NRRIT) to obtain more complete, reliable information about the NRRIT’s financial position in order to have a consistent basis for preparing the fund balance.

We again thank you and your staff for working closely and cooperatively with us these past few months to help ensure that the RRB will be able to meet this year’s reporting deadline of November 15.

cc: The Board
Executive Committee